

Federal Acquisition Regulation

16.402-4

profit or fee, and a profit or fee adjustment formula that (within the constraints of a price ceiling or minimum and maximum fee) provides that—

(1) Actual cost that meets the target will result in the target profit or fee;

(2) Actual cost that exceeds the target will result in downward adjustment of target profit or fee; and

(3) Actual cost that is below the target will result in upward adjustment of target profit or fee.

[48 FR 42219, Sept. 19, 1983, as amended at 62 FR 12696, Mar. 17, 1997; 62 FR 51379, Oct. 1, 1997]

16.402-2 Performance incentives.

(a) Performance incentives may be considered in connection with specific product characteristics (e.g., a missile range, an aircraft speed, an engine thrust, or a vehicle maneuverability) or other specific elements of the contractor's performance. These incentives should be designed to relate profit or fee to results achieved by the contractor, compared with specified targets.

(b) To the maximum extent practicable, positive and negative performance incentives shall be considered in connection with service contracts for performance of objectively measurable tasks when quality of performance is critical and incentives are likely to motivate the contractor.

(c) Technical performance incentives may be particularly appropriate in major systems contracts, both in development (when performance objectives are known and the fabrication of prototypes for test and evaluation is required) and in production (if improved performance is attainable and highly desirable to the Government).

(d) Technical performance incentives may involve a variety of specific characteristics that contribute to the overall performance of the end item. Accordingly, the incentives on individual technical characteristics must be balanced so that no one of them is exaggerated to the detriment of the overall performance of the end item.

(e) Performance tests and/or assessments of work performance are generally essential in order to determine the degree of attainment of performance targets. Therefore, the contract

must be as specific as possible in establishing test criteria (such as testing conditions, instrumentation precision, and data interpretation) and performance standards (such as the quality levels of services to be provided).

(f) Because performance incentives present complex problems in contract administration, the contracting officer should negotiate them in full coordination with Government engineering and pricing specialists.

(g) It is essential that the Government and contractor agree explicitly on the effect that contract changes (e.g., pursuant to the Changes clause) will have on performance incentives.

(h) The contracting officer must exercise care, in establishing performance criteria, to recognize that the contractor should not be rewarded or penalized for attainments of Government-furnished components.

[48 FR 42219, Sept. 19, 1983, as amended at 62 FR 44815, Aug. 22, 1997]

16.402-3 Delivery incentives.

(a) Delivery incentives should be considered when improvement from a required delivery schedule is a significant Government objective. It is important to determine the Government's primary objectives in a given contract (e.g., earliest possible delivery or earliest quantity production).

(b) Incentive arrangements on delivery should specify the application of the reward-penalty structure in the event of Government-caused delays or other delays beyond the control, and without the fault or negligence, of the contractor or subcontractor.

16.402-4 Structuring multiple-incentive contracts.

A properly structured multiple-incentive arrangement should—

(a) Motivate the contractor to strive for outstanding results in all incentive areas; and

(b) Compel trade-off decisions among the incentive areas, consistent with the Government's overall objectives for the acquisition. Because of the interdependency of the Government's cost, the technical performance, and the delivery goals, a contract that emphasizes only one of the goals may jeopardize control over the others. Because

outstanding results may not be attainable for each of the incentive areas, all multiple-incentive contracts must include a cost incentive (or constraint) that operates to preclude rewarding a contractor for superior technical performance or delivery results when the cost of those results outweighs their value to the Government.

16.403 Fixed-price incentive contracts.

(a) *Description.* A fixed-price incentive contract is a fixed-price contract that provides for adjusting profit and establishing the final contract price by application of a formula based on the relationship of total final negotiated cost to total target cost. The final price is subject to a price ceiling, negotiated at the outset. The two forms of fixed-price incentive contracts, firm target and successive targets, are further described in 16.403-1 and 16.403-2 below.

(b) *Application.* A fixed-price incentive contract is appropriate when—

(1) A firm-fixed-price contract is not suitable;

(2) The nature of the supplies or services being acquired and other circumstances of the acquisition are such that the contractor's assumption of a degree of cost responsibility will provide a positive profit incentive for effective cost control and performance; and

(3) If the contract also includes incentives on technical performance and/or delivery, the performance requirements provide a reasonable opportunity for the incentives to have a meaningful impact on the contractor's management of the work.

(c) *Billing prices.* In fixed-price incentive contracts, billing prices are established as an interim basis for payment. These billing prices may be adjusted, within the ceiling limits, upon request of either party to the contract, when it becomes apparent that final negotiated cost will be substantially different from the target cost.

[48 FR 42219, Sept. 19, 1983, as amended at 59 FR 64785, Dec. 15, 1994]

16.403-1 Fixed-price incentive (firm target) contracts.

(a) *Description.* A fixed-price incentive (firm target) contract specifies a

target cost, a target profit, a price ceiling (but not a profit ceiling or floor), and a profit adjustment formula. These elements are all negotiated at the outset. The price ceiling is the maximum that may be paid to the contractor, except for any adjustment under other contract clauses. When the contractor completes performance, the parties negotiate the final cost, and the final price is established by applying the formula. When the final cost is less than the target cost, application of the formula results in a final profit greater than the target profit; conversely, when final cost is more than target cost, application of the formula results in a final profit less than the target profit, or even a net loss. If the final negotiated cost exceeds the price ceiling, the contractor absorbs the difference as a loss. Because the profit varies inversely with the cost, this contract type provides a positive, calculable profit incentive for the contractor to control costs.

(b) *Application.* A fixed-price incentive (firm target) contract is appropriate when the parties can negotiate at the outset a firm target cost, target profit, and profit adjustment formula that will provide a fair and reasonable incentive and a ceiling that provides for the contractor to assume an appropriate share of the risk. When the contractor assumes a considerable or major share of the cost responsibility under the adjustment formula, the target profit should reflect this responsibility.

(c) *Limitations.* This contract type may be used only when—

(1) The contractor's accounting system is adequate for providing data to support negotiation of final cost and incentive price revision; and

(2) Adequate cost or pricing information for establishing reasonable firm targets is available at the time of initial contract negotiation.

(d) *Contract Schedule.* The contracting officer shall specify in the contract Schedule the target cost, target profit, and target price for each item subject to incentive price revision.

[48 FR 42219, Sept. 19, 1983, as amended at 59 FR 64785, Dec. 15, 1994]